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Backgrounder

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The Hazards of a Federal-Provincial Debt Bailout

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The growing difficulties of several provinces in marketing their debt have prompted speculation, particularly in the financial press, that some sort of federal bailout may be needed. A crisis in provincial finances is, however, far from certain. Indeed, realistic provincial fiscal initiatives in forthcoming budgets may well silence the speculation. Nevertheless, debt and deficits remain a problem for both levels of government, one which destabilizes capital markets and makes outcomes much less predictable.

A frank discussion now, therefore, about some of the options and nonoptions makes more sense than a strained and artificial silence. The atmosphere of urgency that would surround any future provincial request for help might pre-empt a thorough public debate about some of the key principles. In fact, the temporary relief that a federal bailout would offer any individual province might be purchased at high cost — economic and political — to Canada as a whole.

"Soft" Options

The potential for crisis is rooted in too much borrowing by all Canadian governments. But the precipitating factor would be a sudden turn in investor sentiment that leaves a particular province, seeking to finance new borrowing and/or refinance maturing debt, without buyers for its securities. Without new cash, various obligations — for example, health care costs, welfare transfers, and interest on outstanding debt — could not be met. A call for immediate federal aid would almost certainly follow. If Ottawa chose to respond, a variety of options can be imagined, only some of which are touched on here, to illustrate the issues.

It has been suggested, for example, that the Bank of Canada could act as a lender of last resort, while insisting that the province undertake the kind of budgetary reforms usually required by the International Monetary Fund (IMF). Among other possibilities, the federal government could guarantee existing or new provincial debt or debt-service costs, or cover provincial needs with *ad hoc* grants. Federal aid could come with conditions of varying stringency.

The Bank of Canada as Lender of Last Resort

Any direct IMF-style role for the Bank of Canada is out of the question. The Bank is a federal institution

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whose powers and responsibilities are laid down by statute; it has neither legal authority nor expertise to run the economic policy of a provincial government. Short of this, however, there are no legal impediments to the Bank's acting as buyer of last resort for provincial debt — by backstopping a new federal agency set up to issue debt on behalf of a province, for example.

Any such prospect is, however, worrisome. When deficits are funded by financial market borrowing, they displace private capital investment, and pile up debts at home and abroad that ultimately have to be paid through higher taxes and exports. Worse, they raise the specter of monetizing public debt — issuing it to the Bank of Canada in return for newly printed money — which is no solution at all. If the Bank were to buy debt on any significant scale, a sharp increase in inflation would shortly follow. (Over its more than 50 years of existence, the Bank's cumulative net purchases of government debt come to less than $20 billion — an amount exceeded by net new provincial borrowing in 1992 alone.) One problem, erosion of living standards, would be replaced by a worse one — renewed inflation, which also erodes living standards, while creating additional injustice and social tension.

The fear of monetization of provincial debt might also prompt a flight from all Canadian-dollar fixed income securities by investors. For years, financial markets have faced the chance that the federal government, which is the Bank's political master, might "solve" its growing debt problem in this way. But the threat is currently limited to Ottawa, which has reassured markets with vocal support of the Bank's anti-inflation strategy. The potential for increased pressure to monetize in support of even a single province would be bound to frighten investors, intensifying the crisis the bailout was intended to solve.

The Risks of Federal Guarantees

There are also problems with any federal backstopping of a province, even if done in a way that keeps the Bank of Canada at "arm's length." Ottawa could, for example, cover interest payments on existing debt with direct grants. But such federal backstops of the debt of any one province would, in effect, guarantee the debts of all.

One consequence would be immediate relaxation of the pressure that interest rate premiums and credit ratings are currently exerting on provincial governments to put their fiscal houses in order. Another would be jettisoning a key principle governing fiscal policies in a federal system — that elected governments should take responsibility for the consequences of their own actions. Taxpayers in one province whose representatives had acted more responsibly and earlier than others would be "rewarded" by covering the interest payments of their more profligate compatriots. Canada is badly stressed by financial quarrels already, and hardly needs the new interprovincial tensions that would result.

As noted already, the root cause of Canada's problem is government deficits, with the consequence that governments at all levels continue to borrow too heavily. The only remedy is to stop. Difficulty in borrowing is a sanction imposed by markets on chronic overborrowers. Any federal move to ease that pressure will allow remedial policies to be delayed. Some provinces might make good use of any extra breathing room — others might not.

Hard Options

If speculation about federal bailouts persists, the federal government must, at some point, announce clearly that it is not responsible for existing or future provincial debts or debt-service charges. Such an announcement might raise some provinces' borrowing costs. But it would not likely make a decisive difference to their ability to borrow, unless they fail to take corrective budgetary measures. Knowledgeable investors should already be aware that no federal guarantee exists.

Any increase in the interest rates charged to provinces might, moreover, be offset by a decline in those charged to Ottawa — which are the key rates influencing other borrowing costs for Canadians. The announcement would reassure markets that Ottawa's debt burden will not suddenly be dramatically worsened by the addition of provincial liabilities, and concerns about monetization would diminish.

If financial markets do not give Canada's fiscally weaker provinces the time to address their

deficits, eventually a crisis will prompt a call for federal aid. In that event, Ottawa must resist the temptation of "soft" options. Markets will need clear evidence that the underlying problems are being addressed. Far better than hidden transfers or *ad hoc* grants would be the temporary federal assumption of trustee-like duties, with a commitment to achieving a balanced budget in, say, two years. Any new federal debt incurred in the process would be added to the province's obligations, and no retroactive guarantee of existing provincial debt securities or unfunded liabilities would be issued.

To conclude, speculation does not make a crisis. Provinces have the immediate option of addressing their fiscal woes credibly. What the speculation does indicate, however, is how destabilizing the federal and provincial debt and deficit situation is becoming.

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